Supreme Court, U. S.
FILED
FEB 14 1977
MICHAEL RODAK, JR., CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1976

No. 76-624

FRANK LYON COMPANY, *Petitioner,*

v.

THE UNITED STATES, *Respondent.*

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

REPLY MEMORANDUM FOR THE PETITIONER

ERWIN N. GRISWOLD
1100 Connecticut Avenue, N.W.
Washington, D. C. 20036
Counsel for Petitioner

Of Counsel:

T. F. CULLEN, JR.
JONES, DAY, REAVIS & POGUE
1100 Connecticut Avenue, N.W.
Washington, D. C. 20036

J. GASTON WILLIAMSON
CHARLES J. GIROIR, JR.
ROSE, NASH, WILLIAMSON, CARROLL, CLAY & GIROIR
720 West Third Street
Little Rock, Arkansas 72201

February, 1977

PRESS OF BYRON S. ADAMS PRINTING, INC., WASHINGTON, D. C.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1976

No. 76-624

FRANK LYON COMPANY, *Petitioner,*

v.

THE UNITED STATES, *Respondent.*

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

---

REPLY MEMORANDUM FOR THE PETITIONER

This reply to the Government's brief in opposition is filed because the Government has failed to face the important issues of equity, tax administration, and precedent presented by the decision below.

1. The principal difficulty with the position of the Government, and the approach of the court of appeals,

is the failure to recognize that taxpayers must plan, and that the Internal Revenue Service should tax such transactions in a fashion which is at least roughly predictable. On the practical as well as the conceptual level, it is proper that this transaction should be taxed as the parties understood it.

On the most simple common-sense level, the taxpayer and Worthen both had substantial and legitimate nontax motives for entering into the transaction and organizing it as they did.[1] They planned in good faith for certain consequences and bargained at arms length on those assumptions. And there is no practical reason not to tax the transaction as it was planned and structured. There is no revenue difference—corporate rates are flat rates and the Government will get the same tax from the petitioner, under its contention, as it would get from Worthen under the Government's contention. The Government's position is primarily formal—to no practical avail—while completely upsetting the reasonable expectations of the parties.

The Ninth Circuit in *Cubic Corporation* v. *United States,* 541 F.2d 829, recognized that the intention and situation of the parties should be a substantial factor in determining tax consequences; there should, in short, be some reason for upsetting good faith tax planning untainted by sham. The Government attempts to distinguish *Cubic* by pointing out that *Cubic* did not involve a sale and leaseback. But the Government fails to show any reason why the intent of the parties should be important in determining whether there was a "sale" in *Cubic* and yet irrelevant here. *See also*

[1] For instance, the terms of the agreement were formed to meet requirements of banking law, and by the competition among bidders.

American Realty Trust v. *United States,* 498 F.2d 1194, 1198-99 (4th Cir. 1974).[2]

2. There is no indication in the Government's brief of how the uncertain "bundle of sticks" approach adopted by the court below can be reliably or predictably used to discern the "economic substance" of a transaction.

In two footnotes (Brief in Opposition at 9-10, nn. 9, 10), the Government dismisses all consideration of predictability in general and fairness to the particular parties, observing that tax consequences must follow "economic substance." But here significant aspects of the "substance" of the transaction are given little or no weight. The Lyon-Worthen agreement was an *arms-length transaction* between two commercial actors, there was no *differential in tax rate* between the two parties, and both had *substantial nontax reasons* for entering into the transaction in its present form. Although there is no contention that the transaction is a "sham," or that tax avoidance was the objective or the result, the bargain is scrambled and the expectations of the parties frustrated.

3. The Government's position is that the Frank Lyon Company's share of the benefits and burdens of ownership is simply insufficient to allow it to take depreciation deductions.

[2] Earlier cases have likewise emphasized the importance of the intent of the parties in determining the "economic substance" of the transaction involved. *See, e.g., Helvering* v. *Lazarus & Co.,* 308 U.S. 252 (1939); *Western Contracting Corporation* v. *Commissioner,* 271 F.2d 694 (8th Cir. 1959); *Oesterreich* v. *Commissioner,* 226 F.2d 798, 801-802 (9th Cir. 1955); *Commissioner* v. *H. F. Neighbors Realty Co.,* 81 F.2d 173 (9th Cir. 1936).

The factual difficulties with this conclusion are outlined in the Petition at 15-16 and throughout the opinion of the district court. Pet. App. A. It is illustrative to note that the Government has made no attempt to explain away the 10-year period between the end of the building lease and the end of the ground lease.[3] During this period, Lyon was at liberty to use or rent the property as it wished while paying the specified ground rental of $10,000 per year. This residual interest makes it clear that petitioner was not a mere "conduit" for loan money as the Government and the court of appeals have asserted.[4]

---

[3] By citing this fact, petitioner does not, of course, accept the Government's characterization of the other burdens and benefits retained by Lyon. This terminal period is merely the clearest example of the Government's refusal to recognize any part of the "substance" of the transaction which does not comport with its own conceptualizations.

[4] The Government relies in its Brief in Opposition far more heavily on Worthen's reversionary interest in the building than did the court of appeals. In its statement of the question presented and in its discussion of *American Realty Trust, supra*, the Government states as fact its conclusion on reversion, though it is a disputed question of Arkansas law which the court of appeals stated that it "need not resolve". Pet. App. 27a, n.6. This question, too, materially affects the "conduit" theory on which the Government's case depends.

The common law rule cited by the Government—that improvements by a lessee revert to the owner at the end of the lease unless the lease provides otherwise—does not deal with the more complicated situation presented here, where the ground lessor has *sold* the improvement to the lessee without any reservation of reversionary rights.

Arkansas law clearly recognizes that one person may own the leased land and another may own the improvements thereon. In *Stirman* v. *Craven*, 33 Ark. 376 (1878), the Arkansas Supreme Court resolved the dilemna of dual ownership of the land and building after the termination of the lease by ordering the property sold and the purchase price divided in proportion to value. *Stirman* followed an earlier case, *Witherspoon and Gilliam* v. *Nichols, Sheriff*, 27 Ark. 332 (1871), was cited with approval in *Butler* v. *Adder—Goldman Commission Company*, 62 Ark. 445, 450, 35 S. W. 1110, 1111 (1896), and in *Storthz* v. *Sanger*, 108 Ark. 154, 161, 156 S. W. 1020, 1122 (1913) and has never been overruled or questioned.

Where the Government does attempt to meet the petitioners' arguments concerning the burdens and benefits of ownership which petitioner bears under the arrangement, its position ignores the practicalities of the situation. Thus, when petitioner points to the fact that it could have sold the building at a profit (Pet. at 16) the Government does not dispute the fact, it merely concludes that, since petitioner could not sell the land, sale profit would reflect appreciation of lease rights and not the building itself. (Brief in Opposition at 8, n.6). This hypertechnical distinction not only ignores rights beyond lease rights which would be conveyed (the right to resale and the other burdens and benefits of ownership which the petitioner points out in its brief), it fails totally to reconcile any appreciation on a sale with its "conduit" theory of petitioner's participation.

In a similar manner, the Government argues that petitioner could not realize any profit or loss on condemnation of the building because the lease required that petitioner pay over to Worthen the amount necessary to restore or replace the leasehold. (Brief in Opposition at 8, n.6). This argument ignores the possibility that the amount necessary to restore or replace the leasehold property may not be the same as the amount of insurance or condemnation proceeds.

Finally, the Government asserts that the risk of Worthen's insolvency is no different than the risk faced

by the guarantor of a loan. (Brief in Opposition at 9). This does not mean that the risk is not a risk of ownership. Nor does this argument deal with the possible opportunity presented by a Worthen insolvency if insolvency leaves the petitioner free to deal with a building that has appreciated in value free of the lease.

Moreover, the conclusion that Lyon was a mere conduit, and the factual determinations and assessment which support that conclusion, were fully rejected by the district court as trier of fact. (See Pet. App. A; Pet. at 7.) The district court found that the option prices represented a "negotiated estimate . . . as to fair market value of the building," but the Government simply rejects this finding. (Brief in Opposition at 7.) The Government is asserting that it understands the dynamics of the negotiation better than the trier of fact, and rejecting the plausible conclusion that the terms were what they were because competition for the investment opportunity put Worthen in a position to demand the terms on which the parties agreed. Pet. at 7; Pet. App. A 13a, 10a.

4. A full appreciation of the facts is necessary to determine the "economic substance" of a transaction. The Government's position—that "economic substance" can and should be determined as a pure matter of law—is a dangerous misreading of the law.

The cases cited by the Government (Brief in Opposition at 13) can be taken as supporting the proposition that when the facts are established the determination of the question whether such agreements are to be taxed as sales or financing transactions is ultimately a legal conclusion. The cases cited do not support the idea that courts of appeals should determine the

facts *de novo* in utter disregard of the findings of the trier of fact; yet this is what the Government seeks here, because in *Lyon,* the findings of the district court upheld the taxpayer at every point.

Although the Government cites *American Realty Trust* v. *United States,* 498 F.2d 1194 (4th Cir. 1974), for instance, the *American Realty Trust* court dealt only in the alternative with the Government's contention that a sale-leaseback could be dealt with *de novo* as a matter of law. The court had declared itself "disinclined to disturb the jury's verdict" since there was enough supporting evidence to preclude a conclusion that the verdict on the sale or financing arrangement question was clearly erroneous. 498 F.2d 1198. The ultimate conclusion may be legal but it must be "grounded in underlying findings of fact." 498 F.2d at 1198.

The *American Realty Trust* court's treatment of the issue as a whole, with its full recognition of the importance of the factual findings and the intent of the parties, provides sharp contrast to the decision of the court of appeals here, and the approach the Government urges on this Court. The two approaches, with their conflicting signals to tax planners, cannot be reconciled except by this Court.

5. In its discussion of this Court's decision in *Commissioner* v. *First Security Bank of Utah,* 405 U.S. 394, the Government has simply scrambled what went on when this transaction was carried out. It says (Brief in Opposition 12-13): "Since the federal and state banking authorities approved the sale and leaseback transaction (*See* Pet. App. A 4a), the rule of *First Security Bank* is inapplicable here."

Yet, it is entirely clear that both federal and state banking authorities refused to approve an arrangement under which Worthen would be the owner of the building.[5] It was because of this that Worthen decided to sell the building to the petitioner, and then to lease it back. It is true that the state and federal banking authorities approved this transaction; but the very reason that they did so was because Worthen was *not* the owner of the building under the agreement between the parties. To say that the petitioner should now be taxed as if Worthen was the owner of the building, and that "*First Security Bank* is inapplicable here" is to stand the transaction on its head. What the banking authorities approved was an arrangement in which Worthen was the lessee. This was the view of the court of appeals. Pet App. 16a. For the Government now to say that "The Federal banking law does not prohibit Worthen from borrowing the money but simply required it to seek the approval of the regulatory authorities" (Brief in Opposition 12), when the Federal banking authorities had expressly disapproved an arrangement under which Worthen borrowed the money and was the owner of the building, is disingenuous.

[5] In footnote 3, page 4, of its Brief in Opposition, the Government erroneously stated that the State Bank Department required a repurchase option at the end of the 15th year of the lease, "but did not otherwise specify the terms of the agreement." It is questionable whether the State Bank Department would have approved an option price at fair market value rather than an agreed upon "figure" or dollar amount.

CONCLUSION

The Government has failed here, as the court of appeals failed below, to reconcile the decision below with the findings of the district court, with applicable precedent, or with the dictates of practical foreseeability and sound tax administration. In order to provide badly needed clarity in this field, the Court should grant the petition for certiorari.

Respectfully submitted,

ERWIN N. GRISWOLD
1100 Connecticut Avenue, N.W.
Washington, D. C. 20036
Counsel for Petitioner

Of Counsel:

T. F. CULLEN, JR.
JONES, DAY, REAVIS & POGUE
1100 Connecticut Avenue, N.W.
Washington, D. C. 20036

J. GASTON WILLIAMSON
CHARLES J. GIROIR, JR.
ROSE, NASH, WILLIAMSON, CARROLL, CLAY & GIROIR
720 West Third Street
Little Rock, Arkansas 72201

February, 1977